RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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Post Office Box 1759, La Jolla, California 92038

26 Letters Per Year • $250 annually

Oct. 12, 1994 **LETTER 1158**

"WEALTH EFFECT" IN REVERSE? The long Treasury bond down 19%, utility stocks down 30%, Transports down 22%, stocks across the board down $300 billion (based on the losses in the Wilshire 5000), the dollar down 12% against the yen -- bear market losses have climbed into the hundreds of billions (bonds worldwide down $1.5 trillion). Meanwhile, the newspapers are announcing that "prosperity is us," but I believe we're moving into the area where the "reverse wealth effect" is going to kick in. What's the reverse wealth effect? It's when **people start to feel poorer**; it's when market losses begin to impact on the emotions and actions of consumers and business.

Up to recently, this has been a bear market of **slow attrition.** Every move, either up or down, was drawn out, tediously extended -- almost boring. But last week the bear ended his period of hibernation. With a **vacuum under the Dow created by the collapse of the Dow advance-decline line** (as described in detail in the last two Letters), the Dow and the market headed lower with a vengeance. *"Market Observers Puzzled by the Decline,"* headlined the *NY Times*. But readers of these Letters were hardly surprised by the belated bear market action.

FOUR STRIKES AND YOU'RE OUT: I just received an interesting letter from Jon Strebler, who was a student of mine many years ago when I gave a series of intermittent lectures at San Diego State University. Jon is an expert chartist and he possesses a fine feel for the markets (maybe his sensitivity to the tide and waves stems from his aquatic experience -- Jon is a veteran surfer). Here's what Jon writes:

"You know about this fascination I have with long-term charts, so check the progression of action as follows:

"(1) About a year ago the D-J Utility Average rolled over through the 250 area, ending a 19-year bull market in utility stocks. Utility stocks are extremely interest rate-sensitive; interest rates, in turn, are normally inflation-driven. **That's one down.**

"(2) During this past summer the D-J 20-Bond Average dropped below the 100 level, ending the long bond bull market that began in 1984. Bond prices move primarily in response to inflation fears. **That's two down.**

"(3) On Tuesday, September 20, the D-J Transportation Average dropped below 1540, terminating a 20-year bull market in those stocks. Transportation companies are especially sensitive to commodity inflation and to cyclical downturns in the economy. **Three down.**

"(4) At this point, the Industrials are the only bullish average of the Dow Jones series. **Three down and one to go.** What are the odds that the Industrials will prevail and that the other Averages will move up? Less than one out of four, I'd say.

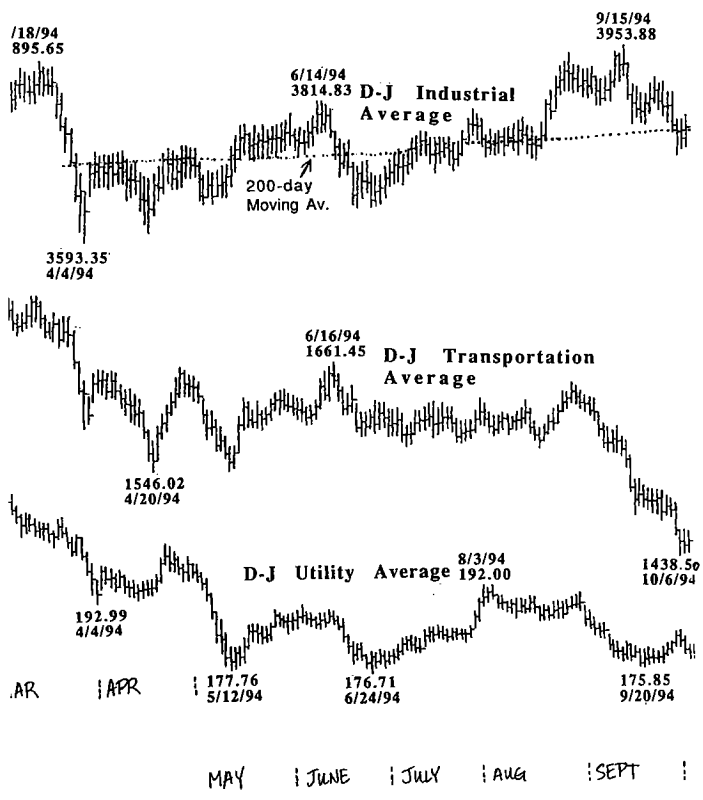
"It would take a lot to turn the Industrial Average bearish at this point and the gold shares are once again ahead of themselves. Hence, barring a 1987-style meltdown (always a possibility), I expect gold to chill out and the stock market to catch its breath for a while here. But by year-end, my guess is that a major bear market in stocks will be evident to all. The Averages have been telling us that, one by one."

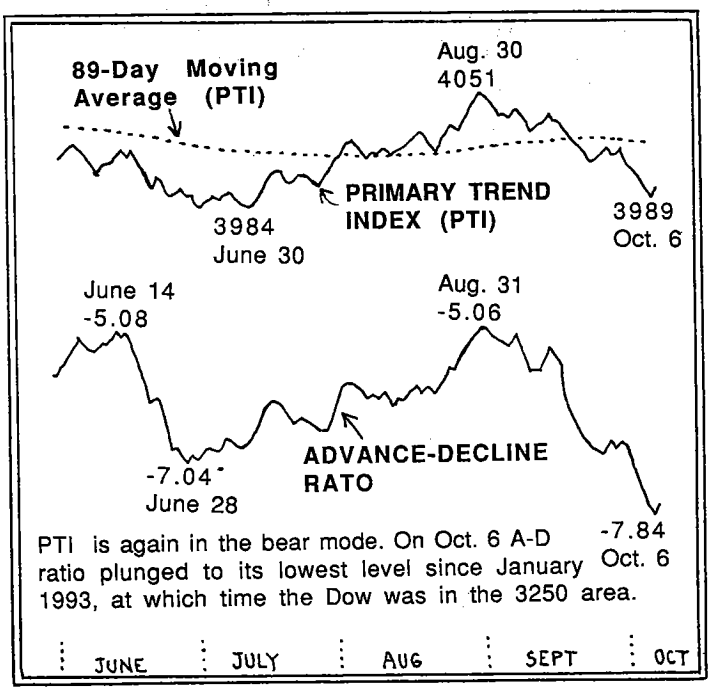
Sept. 30 DJIA 3843.19; PTI 4017; A-D Ratio -6.77
Oct. 7 DJIA 3797.43; PTI 3995; A-D Ratio -7.74
Dow Yield: 2.79%; Dow Price/Earnings: 20.1
Dow 200-day MA: 3789; Dow 30-day MA: 3870
Dow Times Book Value: 3.39; PTI 89-day MA: 4019
Percentage of Undervalued Blue-chips: 13%
Dow Low Risk Buy Index: +38; Gold-PTI: 996
Gold 200-day MA: 385

Russell comment: I received Jon's letter two weeks ago. It appears that we won't have to wait until year-end to catch a glimpse of the bear. Last week he stuck his head out of his lair. And it's becoming increasingly evident (even to the many "perma-bulls") that a bear market is starting to exert its hold over Wall Street.

Meanwhile, the vicious bear market in bonds goes on. By mid-October, if prices stay about where they are now, the total return on long-term Treasury bonds will be a **negative 19%** for the previous 12 months. This would represent the worst performance for bonds since the 1920s. Ah yes, do you remember that less than a year ago Clinton was boasting that his easy money policy had driven rates down to 25-year lows? That was then, this is now.

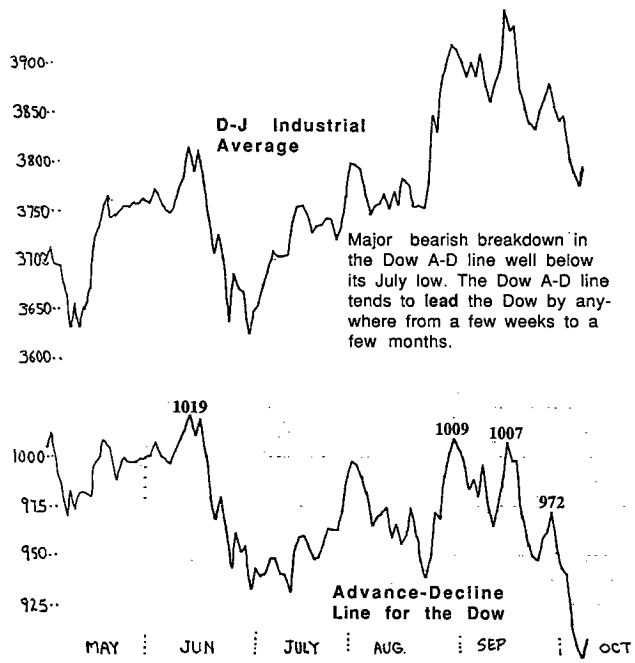
By the way, if you add the bond losses to the current 31% loss in the average price of utility stocks, then you're talking about staggering losses of hundreds of billions of dollars. But the average investor remains blissfully unaware of this early and costly attack by the bear. It seems that investors won't recognize what is happening until the stock market itself and more specifically, the major stock averages (i.e., the Dow and the broad composites) lose 20% to 30% of their value. At that point the bear market will finally be recognized by a frightened and bewildered public.



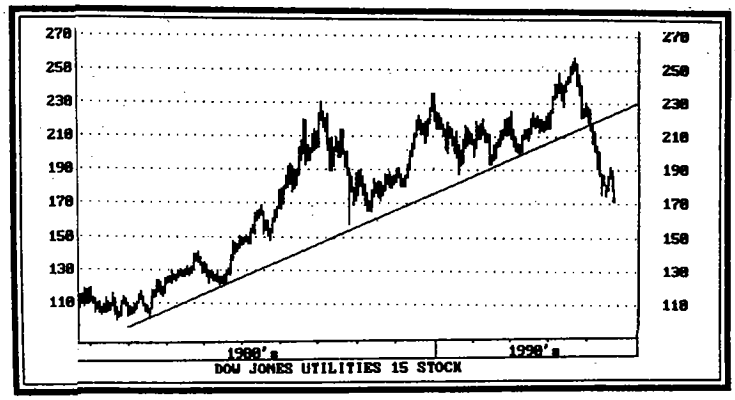


It's obvious that the transportation stocks (rails, trucks, airlines) have been distributed under the cover of what appeared on the surface to be a "strong Dow." I might add that the current and continuing divergence between the D-J Industrials and the Transportation Averages is one of the most persistent and flagrant that I can remember.

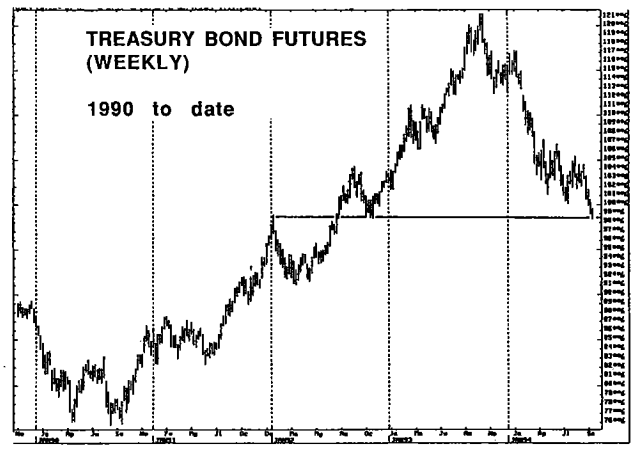
For those subscribers who have been pinning their bullish hopes on the Dow, I trust you have taken seriously my studies of the Dow and its diverging **Dow advance-decline line.** Below is an up-dated chart of the Dow and its A-D line. The divergent action of the Dow A-D line told us that fewer and fewer Dow stocks were providing the upside impetus for the Dow -- while the majority of Dow stocks were participating on the downside -- a prescription for disaster. On October 4, the Dow A-D line crashed to a new low below its June low. Bearish, very bearish action.



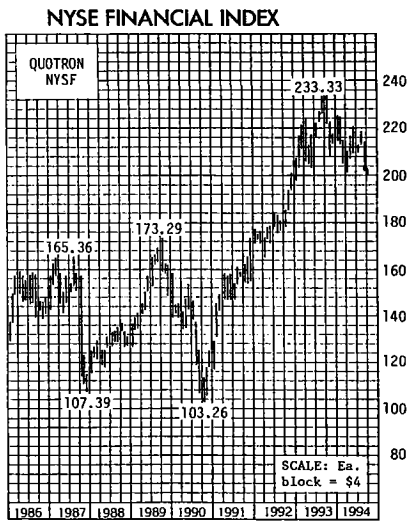
Here is a chart of the **D-J Utility Average,** a chart covering the entire span of the 1980s through the 1990s and up to the present. Not a pretty picture.



Below we see a chart (weekly) of the **Treasury Bond Futures,** going back to January 1990. Rather ugly, wouldn't you say? And in the form of a huge potential "head-and-shoulders" top. Could bonds go down a lot further than anyone now envisions? It's a thought -- and the pattern suggests it.



Last in this series, I'm including a monthly chart of the **NYSE Financial Index.** This broad Index is particularly important since it includes all financially-related NYSE stocks -- banks, S&Ls, stock brokers, finance companies, insurance companies, etc. The chart traces out a complex version of a "head-and-shoulders" top. A decisive break below the "support" level at 200 would be ominously bearish (as this is written the Financial Index is just fractionally above 200). Speaking of the Financials, have you noticed the big declines in the bellwether brokerage stocks? (Chart of the Financial Index courtesy of *Horsey,* Salisbury, MD 21080)



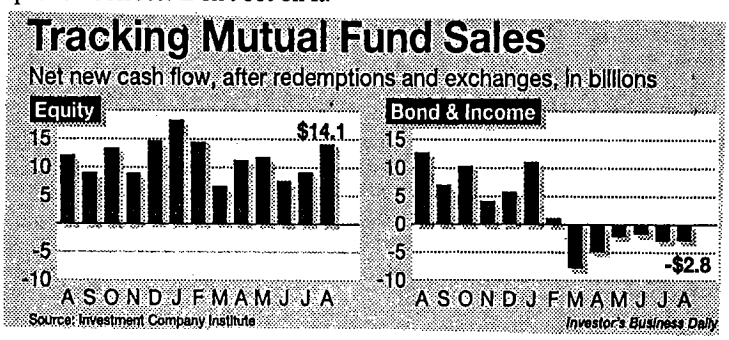
Daily new lows on the NYSE have expanded, and are consistently outpacing daily new highs. The expanding new low list dovetails with the bearish performance of the NYSE advance-decline ratio (see page 2 chart). On October 4 the A-D ratio broke bearishly to a new bear market low. Remember, the **A-D ratio is a proxy for all the stocks on the NYSE.**

Confirming the collapse of the A-D ratio, **Joe Granville,** in his very valuable and exclusive study, states that **773 NYSE stocks** are now within one point or less of their 52-week lows; this is up from the previous count of 737 [Granville: (800) 876-5388].

PTI: For new subscribers, I should explain that my **Primary Trend Index (PTI)** is a composite of eight indexes and averages, each based on **market action.** The composition of the PTI is such that it is literally impossible for the PTI to rise on a trend basis without exerting powerful upward pressure on the market. By the same token it is almost impossible for the PTI to decline on a trend basis without exerting powerful downside pressure on the market.

Note (page 2 chart) that for two months (June 30 to August 30) the PTI trended upwards and that action was accompanied by a rallying Dow. From its peak of 4051 (Aug. 30), the PTI turned down; the PTI has been in a downtrend since Aug. 30.

Amazingly, the public's thirst for mutual funds appears unabated. This chart shows new cash coming into equity funds (August) in the amount of $14.1 billion, the largest net total since last February. At the same time, the public has been taking money out of Bond and Income funds (perhaps, moving the funds into equity funds). Will the public's voracious appetite for mutual funds be proven correct? Don't bet on it.



Market Logic of Ft. Lauderdale, FL runs what I might term the "irony index." *Market Logic* calls it the "Bad News/Good News Index." *ML* writes, *"At 5% both the August and the three-month moving average score of the BN/GN are deep in bearish territory. With just one dividend cut for every 20 boosts, Corporate America is in evident prosperity. Alas, this is a condition typical of market tops."* **Russell comment:** In other words, *Market Logic* cleverly gauges corporate prosperity in terms of dividends boosts vs. cuts. When the boost count runs heavily against the cuts, history tells us that we're close to optimal conditions for corporations and for the economy. When we're near the "this is as good as it gets" stage, then we're also near or at a top for the market.

INVESTMENT POSITION: The bear stays in the box. And not surprisingly, I'm getting fewer and fewer arguments regarding whether this is a bear market or not. If you're still holding a "carefully-chosen, diversified position" in common stocks or a mutual fund, you know it's a bear market. You know it every time you compute the value of your portfolio.

I'm incuding this clip from a *USA Today* column. Let me put it this way -- let's say you're an analyst for a brokerage house -- if you're bullish and right they love you. If you're bullish and wrong, well, that's OK. If you're bearish and right? Well, that's OK too. But what if you're bearish and wrong? **If you're bearish and wrong, you're fired.**

> **Be right, or be bullish:** Consider the brokerage analyst's predicament. Most are in the business of persuading investors to buy — not sell. So in the boss' eye they've done their job if you bite regardless of how the investment turns out. That's why analysts tend to follow only stocks they are willing to recommend. If you buy and the stock goes up, everybody's happy. If you buy and the stock goes down, the boss is still OK with it.
>
> On the other hand, if analysts steer you away from a stock — in effect, turning away business — they better be right. If the stock subsequently rises, the analyst not only turned away business but also gave bad advice. That spells career trouble. And it illustrates why there are so many more buy opinions on Wall Street than sell opinions. In mid-August, Zacks Investment Research tallied buy and sell recommendations from 2,500 analysts and found that the buys outnumbered the sells more than 10 to 1.

I place a lot of emphasis on **correct procedure** in investing. Correct procedure in a primary bear market dictates that you be *"out of stocks and on the sidelines."* And that's where I want all my subscribers to be. Gold is the one other place I've suggested you might be. For maximum safety and peace of mind, I recommend gold coins (I just bought more Krugerrands, myself). For the more venturesome, gold stocks (Placer Dome, Homestake, American Barrick, the Canadians Franco Nevada and Euro Nevada, plus Agnico Eagle, ASA, and for those who don't want to be bothered picking individual stocks I like the Benham Gold Equity Fund).

The overriding important stance, however, is to avoid losses in common stocks and bonds during a bear market. I realize that it's venturesome and exciting to position yourself for a possible profit, but it's far more important to avoid losses. And in a bear market the odds are overwhelmingly in favor of losses. Remember, I've said over and over again, **"In a bear market, the person who loses the least is the winner."** Believe it.

MARKET PHILOSOPHY: One of the things which I've found was most difficult to learn -- to trust my own interpretation of the primary trend of the stock market. The following have helped me most in this area: (1) constant study and an historical market perspective, (2) 45 years of real-time experience dealing with the markets, (3) a basic faith in and understanding of the Dow Theory.

Day after day we see this market bounce up or down in response to this or that rumor or actual event. But I know that if my interpretation of the Dow Theory is correct, if the primary trend of the market has indeed turned down, then it's simply a **matter of time** before all the averages and a great majority of stocks decline in harmony with the primary bear trend.

By why, you ask, is the Dow still holding well above its critical April low? Why, in other words, doesn't the Dow break below its April low, thus re-confirming the bear market? Here's the way I see the situation.

First, I'm convinced that the Averages have topped out. I'm convinced that **at their January-February highs, the Averages discounted the best that could be seen ahead.** Once they've done that, then, by definition, the bull market is over, and the primary direction of the market is **down.** But all the Averages do not have to collapse immediately. The Transports and Utilities have already fallen apart as has the A-D ratio and the bonds.

Now, as I see it, the Dow is "hovering in space," simply passing time. This "trendless-ness" will continue until the D-J Industrial Average senses definite forthcoming deterioration in the blue-chips. Once that happens, the Dow will follow the other Averages down, under its April low of 3593.35. The timing? It could happen in a few weeks, a month, many months. According to Dow Theory, **there is no time limit.** The bear is in no hurry.

Two more points: (1) I believe the funds are selling a lot of their lesser or secondary stocks while sticking with the big, well capitalized blue-chips. That's the reason the Dow has performed so much better than the average stock. Or to put it another way, that's why the Dow has held in the face of the collapsing A-D ratio.

(2) The economic news remains favorable. But in the face of the favorable news, why have most stocks declined? Answer: the majority of stocks are "marching to the sound of a different drum." That drum is the economic deterioration that the market senses,

deterioration that will become apparent somewhere ahead. Yes, somewhere ahead the news will turn bad. When that happens the bear market will move into its second phase.

NOTES & QUOTES: I opined, a few Letters back, that if we get a bear market down-leg between now and election time (November), it will simply add fuel to a wholesale "booting out" of incumbent politicians (mostly Democrats). Prepare for it. In New York Governor Cuomo is running behind a virtual unknown, state Republican senator George Paataki. In Texas, Governor Ann Richards appears to be in trouble. Dem. Senator Dianne Feinstein is fading fast here in California as is California governor-candidate Kathleen Brown. Democrat Tom Foley, the speaker of the House, is in deep trouble in Washington. And in Massachusetts dear old Ted Kennedy is facing the biggest fight of his long political life. It looks like one helluva November.

But wait, Washington columnist Paul Gigot (*WSJ*, Sept. 30) seriously puts forth the argument that the Dems may not run Clinton in '96. Writes Gigot, "While dropping Clinton may seem crazy, or at least wildly premature, it's the private buzz of much of Washington these days. Last January a Democratic senator, a well-known potentate, wisecracked in a visit to this newspaper that by 1995 Democrats in Congress might be trying to get rid of Mr. Clinton while Republicans work to keep him on the ticket." **Russell comment:** Clinton is such politicial poison that it would not surprise me at all if the Dems booted him off the ticket in '96. When a Prez is this unpopular, then politically, it's every man in the party for himself.

* *

How 'bout that Jimmy Carter -- darned if he hasn't become Clinton's unofficial Secretary of State. And as a compromiser to dictators, there's no one better. Clinton described Cedras as a thug, a dictator, a killer of priests and orphans. But did that stop Jimmy Carter? Hardly, why Jimmy gave Cedras the same treatment that he gave Kim Il-sung in North Korea, which means he came home with Clinton's pockets picked clean. So they make quite a pair -- Clinton waffles and Carter gives away the waffles and the waffle iron. Is this a great administration or what?

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My friend, Christopher Wood, has written a new book entitled, "The End of Japan Inc." (Simon & Schuster, $23.) Chris is one very smart guy, and he's written a very important book -- one that I take seriously. Chris was the *Economist's* former Tokyo and NY Bureau chief (he now specializes in emerging markets for Morgan Grenfell in London). Among Chris' shocking forecasts: (1) Japan will soon unload US real estate holdings acquired in the '80s, such as Rockefeller Center. (2) Japan's grip on the electronics industry will disappear and American companies will take over. (3) Japan's automakers will have to radically change their acclaimed management techniques and production quantity, leading to huge layoffs and societal unrest. (4) Japan's politics will be marked by ideological conflict for the first time since the rise of militarism in the 1930s. (5) Japan will be forced to re-arm to address the new balance-of-power realities in post-Cold War Asia. If all this is true, we can look for a major long-term decline in the yen (which is now about 40% overpriced vs. the dollar on a purchasing-power-parity basis).

* *

I wrote an article which appeared in the Dec. 28, 1959 *Barron's*. The article extolled the virtues of the short interest ratio. But today I pay no attention and give no credence to the huge and rising total of shorts on the NYSE. Why? Because the short interest today is meaningless. Speculators hedge their shorts by matching them with longs; thus they have offsetting positions in stocks. As the speculators get more bearish, they put on more hedge shorts. Then when they think the market is getting ready to fall, they will sell their longs, leaving them with only shorts. Advantage, these speculators can be short without worrying about the Exchange's strict up-tick rule (the rule is that you can only put out a short when a given stock is on an up-tick). Thus, by selling their longs, the speculators have circumvented the Exchange rule in that they are automatically short as soon as they sell their long positions.

* *

George Soros (the world-famous financier) and Paul Reichmann (the world-famous real estate operator) teamed up last year to run a real estate fund. The high-powered partnership was hailed in financial circles as heralding the end of the global real estate slump. They set up the Quantum Realty Trust and raised $525 million. The partnership bought a slew of real estate in London. Alas, the results have not been good. The shares price (set by a London dealer) are down more than 22% from their early January peak. And the London dealer, rather surprisingly, is willing to bid only $121 for the shares when the shares' holdings are valued at $135.

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On a happier note, Microsoft is looking to multimedia for its future growth. Microsoft's consumer group comprises around 600 of the company's total 15,000 employees. But the multimedia group's sales doubled last year, making it the fastest growing group in Microsoft. CEO Bill Gates expects the multimedia group to be the largest in Microsoft within five years.

Incidentally, most people don't know how Microsoft hit the big time. IBM was looking for a microprocessor that would make 8088 circuits work as a computer. They turned to a little software company run by a Harvard drop-out named Bill Gates. In a famous ruse, Gates said he could deliver. Gates didn't have a system, but he turned to a little company a few miles away, Seattle Computer Products, and bought a system. He polished up the system, renamed it MS-DOS ("Microsoft disc-operating system"), and licensed it to IBM. The was the beginning of the trail that was to make Bill Gates the richest man in America, with 90% of the world's computers now carrying Microsoft's operating system. Apple, by the way, would not license its own easy-to-use operating system, an unbelievable mistake. Only a few weeks ago Apple reversed its policy and decided to license the Mac system to other computer makers. But it is late, late, probably too late. The world runs on the Microsoft systems.

* *

What's a derivative? A derivative is a vehicle that represents an underlying asset. For that matter, a stock is technically a derivative since it represents a share in a corporation. But when we talk about derivatives, we are usually talking about futures or options. A future is a contract for future delivery of goods, article or services or an index or an interest rate. In other words, a future may represent a call on anything from a metal to a food to oil to an interest rate or even to the CRB Index or the S&P 500.

And option gives one the right, but not the necessity, of buying or selling a future, all within a specified period of time. So that an option is actually a derivative of a derivative.

Lately, options have been getting (unfairly) a bad name. This has occurred because certain option buyers or sellers did not understand what they were doing or did not understand risk management. There's nothing inherently bad about an option any more than there's something inherently bad about a stock. But if you have $5,000 in capital and you buy $10,000 worth of GM on margin, and GM heads down, you're in trouble. If you're running a money market fund and you're trying to keep your unit at one dollar by way of buying options and you're wrong on your buys -- you're also in trouble. You're in big trouble, since you've screwed up with a supposedly conservative public fund.

Interestingly, the dollar was once a derivative, since it was a proxy for a specific weight of gold or silver. A dollar is no longer a derivative, since it does not represent anything of intrinsic value, it is simply a unit of exchange printed by the government and accepted by the people.

* *

If you have any interest in art, and you're anywhere near San Diego, I urge you to see the great Egon Schiele exhibit at the San Diego Museum of Art in Balboa Park. Schiele (1890-1918) was a daring original, a great sketcher and an artist whose reputation is climbing rapidly. He died at the tender age of 28 during the great influenza epidemic of 1917-18. The last major Schiele exhibit was 30 years ago at the Metropolitan in NYC.

By the way, public interest in art has boomed in recent years, due to a large extent (in my opinion) to the sky-rocketing price of art. Back in 1940 when I was in high school, I would often visit New York's Museum of Modern Art (I was a student at the Art Student's League). At that time it was not unusual to see a grand total of ten or 15 people in the entire museum. Today, the museum is generally crowded and for major exhibits there are long lines of people waiting to buy tickets.

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Dean Witter's economists doubt that the US can grow as fast as many of its overseas competitors. One reason -- too many US lawyers and lawsuits. They write, "Excessive legislation has been mirrored by excessive litigation, further choking US growth. With 5% of the world's population, the US has 70% of the world's lawyers. It is estimated that the annual direct and indirect costs to the American economy of liability suits, higher insurance rates, defensive medicine, etc. is nearly $400 billion -- approaching 10% of the total national output. Some estimates place the cost as high as 15% . . . In Japan there is one lawyer for every ten engineers; in the US there are 500 lawyers for every ten engineers. Which country can be expected to grow faster?" **Russell comment:** Hey, my wife's a corporate lawyer, take it easy. Mmm, but why is she always so busy?

* *

Back at the turn of the century two young girls became good friends. One was my mom, Hortense Lion, the other was Amy Snyder, an avid tennis player. The two grew up together in New York City. Many years ago (I don't know exactly when) Amy moved out to San Diego with her husband. My mother, at my suggestion, moved to San Diego in the '60s. My mom was born in 1898 in the age of the horse and carriage; she died in 1990 at the age of 92 in the age of computers. Amy and my mother remained fast friends all their lives. On Sunday, October 2, they gave a party for Amy. It was a birthday party, Amy had just turned 100. There were about 80 people at the party, friends, Amy's offspring, their kids, well-wishers, admirers. When Amy saw me she brightened. I gave her a big hug and asked her how she felt. She said, "Fine, except my back hurts a little." I said, "Amy, after 100 years something's gonna hurt." We both had a good laugh. Amy is one tough old lady -- she was standing, shaking hands, hugging, talking away, introducing people. I said, "Amy, why don't you sit down?" She answered, "I can sit down any time, no, I'm having fun." And she really was having fun. I guess there's nothing like a birthday when you're a hundred.

* *

O Gad, O. J.: So far on the Simpson case 2,700 pages of briefs have been filed; 1,000 reporters and media support people are covering the trial; $1 million spent so far on the defense; $328,000 spent by the prosecution; 499 articles in the *LA Times* in which a "Simpson" was in the first paragraph; 50 news organizations with permanent seats in the press room, plus 19 TV set-ups; 25 media trailers parked around the courthouse; five media platforms erected across the street from the courthouse; 70 nights in which TV's Hard Copy has televised a story on the case.

* *

Mike Espy, our Agricultural Secretary, is gone, following a long line of Clinton's chronies. Mike made the mistake of acting like one of the Clinton bunch, taking free rides on airplanes, taking free jaunts to the Superbowl. Problem was that the free stuff came from Don Tyson, the big chicken farmer from Arkansas, who owns a firm that Espy was supposed to oversee. Said the *WSJ, "We'll bet Mike Espy wishes he never heard of Arkansas. The place seems to function internally for the state's insiders as a kind of Twilight Zone, with no recognition line between private interests and public office."*

Russell comment: The *Journal's* got it right. Clinton and his crew ran Arkansas as if it was their own personal fiefdom. Then Clinton and Hillary tried to bring the Arkansas culture to Washington. You know something -- it didn't work. It didn't work because Washington is run on a two party system while Clinton's Arkansas was run and owned by a single party of insiders -- the Democrats.

INFLATION -- DEFLATION? Here's one question I get asked more than any other. *In a bear market is it possible to have inflation? Or more probably, won't the bear market produce guaranteed deflation?*

Does anyone have the correct answer to this one? My honest opinion? There's absolutely no way of knowing with certainty whether this bear market will produce inflation or deflation. As a general rule, I would say that primary bear markets produce deflation. When stocks and bonds get hit and hit hard, that generates losses, massive losses. Consequently, people feel poorer, corporations suffer with many edging towards or actually going bankrupt. Dividends are cut, home prices come down, unemployment increases. There's no question about it -- classic bear markets produce losses and deflation.

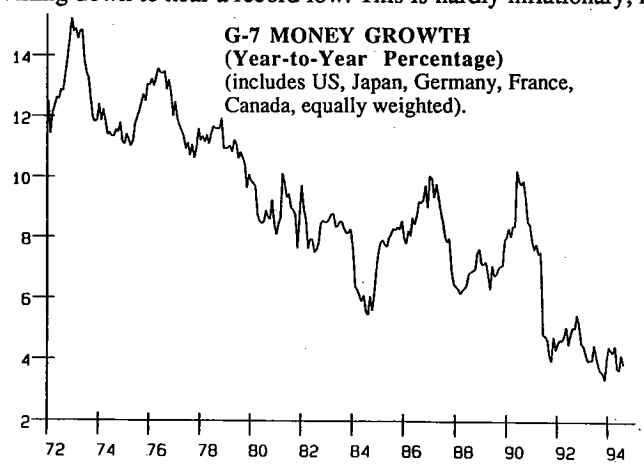
But will this be a classic bear market? Today, almost every nation in the world is expanding economically or at least trying to expand. The political pressures on governments to expand are powerful in the "new world" of the '90s. In order to grow, every nation needs capital, capital and more capital (which is the basic reason why world interest rates have been rising). Today governments demand growth and governments can put pressure on central banks to boost reserves. Furthermore, today governments have a mandate to provide jobs and to fight economic contraction. That wasn't true to earlier times.

As you know, my position is that we're faced with a major, a "Big Daddy," bear market. And personally, I find it hard to believe that a severe bear market won't produce costly losses, dividend cuts, rising unemployment and -- deflation.

But something new has been added to this situation. This bear market is starting out with the US generating record current account deficits. This bear market is starting with the US national debt pushing $5 trillion. It's starting out with the US producing additional debt of $1 billion a day. It's starting out with an incredible total US debt structure (government, corporate and private) of $15.9 trillion.

With this pressing burden of debt, I find myself wondering whether the US economy can hold together at all, once the bear forces really take hold. And what about the dollar as the bear market gathers momentum? If the dollar collapses, I would think that the Fed would be forced to raise interest rates. What, rising rates during an economic contraction? Yes, it's possible.

Another strange phenomenon is bearing down on the world's economies. It's expressed in Ed Hyman's chart of the rate of G-7 money creation. The chart shows the rate of money creation sinking down to near a record low. This is hardly inflationary, no,



it's really quite deflationary. But won't the world's central banks be fighting this trend? They'll certainly try, and that would be inflationary.

Conclusion: In the end, my conclusion is that we'll simply have to play it by ear. As of now, you can make a case for either inflation or deflation.

Today we're not experiencing wild inflation. With all the pumping and interest rate-lowering that the Fed has administered over the last three years, we might have expected runaway inflation by this time. Yet, so far inflation is subdued. And gold cannot seem to climb over 400.

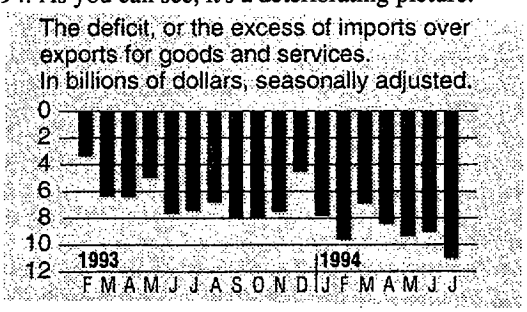
So I keep wondering -- are **powerful cyclical deflationary forces** operating at this time? Are we dealing with "hidden" deflationary forces that are countermanding the expected forces of inflation? Are the destructive forces that produced this bear market the same forces that are holding back inflation? Only time will tell.

DOLLAR and GOLD: The most important single background factor for the dollar is money flows. In other words, are world money flows moving toward the US or away from the US?

To put it mildly money flows are not now favorable for the US. Remember, as far as the US budget is concerned, the US, annually, spends 30% to 50% more than it takes in. To make up for the disparity, the US must either (1) create dollars, a process which is basically inflationary, or (2) receive inflows from foreign sources.

It has become increasingly difficult for the US to attract foreign money. Japan has its own severe economic problems and what money it does spend outside of Japan is now going to Asia. Germany has its own problems, including re-financing and re-building East Germany. And US investment money is now flowing out to foreign stock markets, since it is generally conceded that "overseas is where the real growth is."

This chart from the *NY Times* traces the US trade balance during 1993 and '94. As you can see, it's a deteriorating picture.



All of the above suggests continuing long-term pressure on the dollar. Which brings me to a subject which I touched on in the last Letter -- the possibility of coming world deflation. I think it's going to happen. I believe that what we're seeing now is a **deflating of the financial "bubbles"** that have been created in both the US and Japan. Real estate prices in Japan have been coming down hard, as has their stock market. Japan's Nikkei stock average, having temporarily rallied above 21,000, is now back in the high 19,000s (the bull market high for the Nikkei was just under 40,000). The US market you know about.

Let's now turn to the case for **GOLD**. If there's to be world inflation, as most people appear to believe, then the case for gold is obvious. When more paper is being created, it takes more currency (dollars, yen, D-marks, etc.) to buy an ounce of gold. Few dispute the fact that gold tends to go up with inflation.

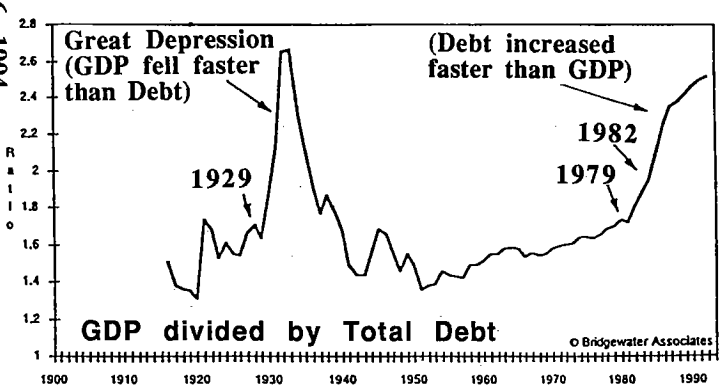
But how about world deflation? What happens to gold in the event of serious world deflation? Ponder this -- the dollar is nothing but a piece of paper backed by "confidence." Only confidence in the US government and its edict that *"this note is legal tender for all debts, public and private"* (you can read this on the face of every one dollar bill) allows the dollar to survive as a viable medium of exchange. We know that pre-1934 the dollar possessed value because the dollar represented a call on **something of intrinsic value,** a specific amount of gold or silver. Today, the dollar represents a call on absolutely nothing.

The big question -- let's say the world sinks into deflation. Remember, there is a total of $15.6 trillion in debt of all kinds in the US. To carry this debt at an average figure of say 6% requires payments of roughly one trillion dollars a year. During a deflation it would be literally impossible to generate anything like that amount of money.

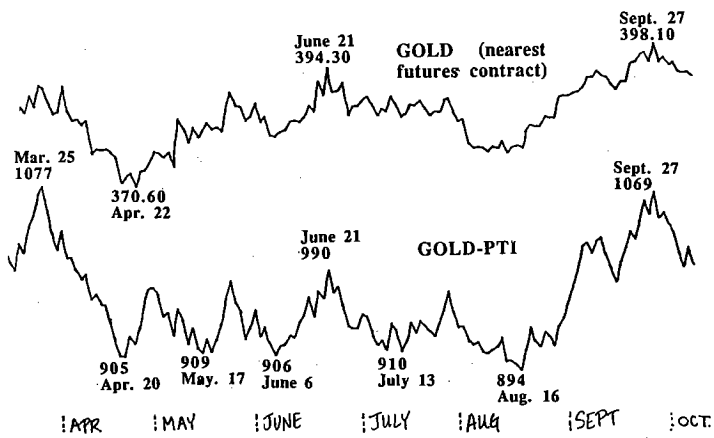
So what would happen? Debts would collapse. Companies and individuals with high debt structures would go bankrupt. Confidence in both debts and the dollar would cave in. With the dollar crashing, confidence in all paper money would slump. Now remember, the only thing causing people to hold or accept dollars is **confidence.** If that confidence collapses, what would a dollar be worth? Would it be worth anything? Would anyone accept dollars for goods or merchandise?

One of the arguments I am constantly confronted with is, "Hey, let the debt rise -- rising Gross Domestic Product will take care of any debt rise." Yeah, right, assuming GDP keeps moving up forever. But things change.

This is a chart showing the ratio of GDP to total US debt. Keep in mind that debt remains in place -- but **GDP can change rapidly.** For instance, during the 1930s GDP crashed, dropping 50% from its highs. This sent the debt/GDP ratio skyward, as seen on the chart.



Note that during the 1980s this ratio rose simply because debt increased faster than GDP. But what happens if the debt continues to increase and GDP again slumps (maybe not as horrendously as during the '30s, but nevertheless GDP slumps)? The GDP/debt ratio would shoot sky-high, and the pressure on the economy would be massive. In that case, I would think confidence in the dollar would collapse and people would rush to swap dollars for gold as fast as they could. There would be a veritable panic to swap "worthless" dollars for real tangible wealth, real money -- gold.



Recently I had the feeling that too many people (and too many publications) had become **too bullish** on gold. Normally, that means that gold is ready to correct or consolidate. And that's where I think gold and the gold shares are now. The shares have put themselves ahead of the metal, which is why on any corrective action the stocks tend to back off quickly while gold backs off grudgingly.

What's this! San Diego Chargers 5-0, only unbeaten team in the NFL. Next Sunday -- at the Big Easy.

NEXT MAILING: Oct. 26, 1994